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TAGS: ECON EFIN ETRD SF
SUBJECT: HIGH MARKS FOR SOUTH AFRICA'S ECONOMY: THE IMF'S 2007 ARTICLE IV REPORT

¶1. (U) Summary: The IMF's 2007 Article IV report for South Africa reports that the country is experiencing record levels of growth on account of strong domestic demand and favorable external conditions. Planned investments in infrastructure should expand the growth potential even further in 2007-12. In the meantime, the strong performance is causing inflation and has led to a large current account deficit. The current account deficit is financed by inflows of portfolio capital, leaving the country exposed to shifts in global investor sentiment. The exchange rate is not seriously misaligned. Surveys of competitiveness rank South Africa slightly above large Latin American economies such as Brazil or Mexico. Trade liberalization has stalled as South Africa awaits the outcome of trade negotiations and implements a new industrial policy. With the economy growing above capacity and inflation rising, the SAG must decide whether to raise interest rates further, or wait to see whether interest hikes after mid-2006 will cool growth without further action. End Summary

The IMF Article IV Report

¶2. (U) Experiencing record-high GDP growth, South Africa is reaping the benefits of sound macroeconomic management and favorable external conditions, according to the International Monetary Fund (IMF). The IMF is concerned, however, that inflationary pressures are building up in the economy and that South Africa's large current account deficit leaves the country exposed to a "sudden stop" in capital inflows should investor sentiment toward emerging markets turn negative.

¶3. (U) The IMF's views can be found in the report of its 2007 Article IV consultations with South Africa, available at www.imf.org/external/pubs/scr/2007. Published in July, the report was based on consultations between IMF staff and SAG officials and private sector representatives in South Africa in May 2007.

The Good News: Growth is Strong

¶4. (U) Driven by strong domestic demand, South Africa's economy is undergoing its longest expansion on record, with GDP growing by 5 percent in 2006 for the third year in a row, the IMF reported. Household consumption is being fueled by growing disposable income, low interest rates (until late

2006), and wealth effects from rising asset prices. Private and public sector investment is buoyant due to high levels of business confidence and SAG infrastructure spending.

¶5. (U) The sustained expansion lifted total employment by 4.1 percent in the year ending September 2006. However, the unemployment rate declined only modestly, to 25.5 percent, as labor force participation rose significantly.

¶6. (U) As a result of investments in electricity, ports and railways, the IMF projects that potential GDP growth will rise from 4.1 percent per year in 2002-06 to 4.9 percent per year in 2007-12. In 2006 alone, parastatals raised their real level of investment by 19 percent. Note: The SAG is more optimistic than the IMF about the outlook for capital formation, employment and productivity. It projects potential annual growth rising to above 5 percent in coming years. The SAG's official goal is to achieve growth of 6 percent per year in 2010-14. End Note.

The Bad News: The System Is Under Stress

¶7. (U) The IMF views near-term prospects as broadly favorable, with GDP growth of 4.7 percent projected for 2007. However, the continued growth of domestic demand in combination with capacity constraints -- as evidenced by record-setting capacity utilization rates and emerging scarcities of electricity, cement and steel -- is intensifying price pressures and could widen the already-large current account deficit. The IMF expects inflation to remain above 6 percent in the near term. It projects that the current account deficit will exceed 6 percent of GDP in 2007 and 2008.

¶8. (U) According to the IMF, the main downside risk lies in South Africa's large current account deficit, which was 6.5 percent of GDP in 2006. The deficit is the result of rising investment and low national savings, and is financed largely by portfolio inflows, not foreign direct investment. The IMF warns that a drying up of global appetite for emerging markets or a substantial rise in global interest rates could prompt a sharp depreciation of the rand, followed by equally sharp interest rate hikes by the Reserve Bank to keep inflation at acceptable levels. However, the Fund believes that South Africa's strong fundamentals -- including low external debt and a sound financial sector -- would limit the impact of external shocks. Note: The current account deficit exceeded 7 percent of GDP in the second quarter of ¶2007. End Note.

¶9. (U) The IMF projects that average growth in 2007-12 will be slightly lower than the potential growth rate (4.8 percent versus 4.9 percent, respectively). This should cause the current account deficit to narrow to about 4.5 percent of GDP by 2012.

Competitiveness

¶10. (U) The IMF noted that the rand has fluctuated without a definite trend since mid-2006, when it depreciated markedly after a period of turbulence in global markets. The IMF could find no strong evidence of serious exchange rate misalignment, though it did acknowledge that estimates of the equilibrium exchange rate are difficult to make. The IMF endorsed the Reserve Bank policy of allowing the exchange rate to float while building up reserves in order to bring South Africa's reserve balance in line with other emerging markets.

¶11. (U) The Fund recommended that competitiveness concerns

be addressed by measures to raise productivity and reduce costs, not by manipulating the exchange rate. The IMF noted that surveys of competitiveness usually rank South Africa slightly above large Latin American economies such as Brazil or Mexico. According to these surveys, South Africa ranks well on business and government efficiency. It ranks poorly on infrastructure, broadly defined to include human capital.

Bones of Contention

¶12. (U) While praising South Africa's sound macroeconomic policies, the IMF noted areas of disagreement with the SAG:

-- The IMF is concerned that the SAG's new industrial policy could introduce economic distortions. It recommended that industrial policy interventions be of short duration and limited to cases of clear market failure.

-- The IMF suggested that the SAG resume the process of trade liberalization and tariff simplification, which has stalled in recent years. In reply, the SAG argued that reforms in this area should reflect the outcome of multilateral negotiations and be considered in the context of the new industrial policy.

-- The IMF advised the SAG to consider revisions of labor market laws that inhibit job creation.

-- The IMF believes that privatization would enhance the efficiency of state-owned companies. However, the SAG prefers to restructure parastatals and sell off non-core assets rather than pursue wholesale privatization. Comment: The SAG is actually creating new parastatals, such as Infraco, a new state-owned broadband network. End Comment

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Comment

¶13. (SBU) South Africa is in the enviable position of having to manage the consequences of growth. Developments since the Article IV report was published have only reinforced the Fund's principal conclusions: inflation has mounted, the

current account deficit has widened, and the battering taken by the Johannesburg Stock Exchange in August underscored the economy's vulnerability to global mood shifts. The SAG has a long-term strategy (plus the cash) to invest in infrastructure and boost the growth potential of the economy. With the economy growing above capacity right now, however, authorities must decide whether to raise interest rates further, or wait to see whether a series of interest rates hikes after mid-2006 will finally kick in and cool growth without further action.
Teitelbaum